United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

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United States Court of Appeals
FOR THE SECOND CIRCUIT

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P/S

SUSAN TANNENBAUM,

Plaintiff-Appellant,

—against—

ROBERT G. ZELLER, *et al.*,

Defendants-Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

**BRIEF FOR DEFENDANTS-APPELLEES
F. EBERSTADT & CO., INC.; F. EBERSTADT & CO., MANAGERS AND DISTRIBUTORS, INC. and ROBERT G. ZELLER**

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December 17, 1975

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BRIEF FOR DEFENDANTS-APPELLEES F. EBERSTADT & CO., INC.; F. EBERSTADT & CO., MANAGERS AND DISTRIBUTORS, INC. and ROBERT G. ZELLER

This is an appeal from a judgment entered for defendants after trial in a derivative action brought by a shareholder of Chemical Fund, Inc. ("Fund"), a mutual fund, to recover on behalf of the Fund for what she contends was an unlawful failure by the Fund to seek rebate or "recapture" of portions of its brokerage commissions through a variety of devices which plaintiff suggests.

The District Court found that the Fund's Board of Directors had carefully considered the whole question of recapture on numerous occasions over a period of many years and had rejected recapture in the informed exercise of independent business judgment. That, the District Court held in dismissing the complaint, was the end of the matter. (It is a stipulated fact in this case that at all relevant times a majority of the Fund's directors was independent and not "interested" (App. A-29)).

The Questions Presented

1. Was it error for the District Court to hold that "recapture" of Fund brokerage commissions was a matter for determination by the Fund's Board of Directors in the informed exercise of independent business judgment?

2. Was it error for the District Court to hold that the Fund's failure to seek recapture of brokerage commissions was not a violation of the Fund's certificate of incorporation or of the management and distribution contracts between the Fund and its manager-distributor?

Statement of the case

A. The parties

The Fund, a Delaware corporation, is an open-end investment company or "mutual fund" registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1 *et seq.* Its investment objective is to attain growth of capital and income by investing in companies whose business is in certain aspects of the sciences (App. A-28).

As required by Sections 5(a)(1) and 2(a)(32) of the Investment Company Act (15 U.S.C. §§ 80a-5(a)(1), 80a-2(a)(32)), the Fund stands ready at all times to redeem its shares for their "net asset value", computed in accordance with the rules and regulations of the SEC, 17 C.F.R. §§ 270.22c-1, 270.2a-4 (Ex. N, p. 7-8). It must, therefore, continuously offer new shares to the public in order to offset redemptions; otherwise, redemptions might require the untimely liquidation of portfolio securities.

As of December 31, 1965 the Fund had total net assets of $433,849,751. At the time of trial, the Fund's total net assets were more than $700,000,000 (App. A-52, 28; Tr. 22).

The Fund's growth is attributable both to its excellent record of investment performance (App. A-77, Tr. 22-28, Ex. K) as well as to its superior record of sales (Tr. 28-30; Ex. L). The Fund's expense ratio, *i.e.*, the amount of expenses incurred by the Fund per dollar of Fund assets, has been among the lowest in the mutual fund industry (App. A-77, 322; Tr. 30-31; Ex. 93, Schedule "A"; Ex. 94, Schedule "A"; Ex. 95, Schedule "A"). Moreover, as the District Court found, the rate of the Fund's portfolio turnover (and, consequently, the level of brokerage commissions which it has paid) has been below that of the mutual fund industry on the whole (App. A-77-78).

The defendant F. Eberstadt & Co., Managers and Distributors, Inc. ("M&D") is the Fund's manager and the distributor of its shares pursuant to written contracts. M&D makes investment recommendations to the Fund's Board of Directors and, subject to the Fund's Board of Directors, manages the business and affairs of the Fund. It also furnishes the Fund with office space and ordinary clerical and bookkeeping services (App. A-28, 29, 53). The compensation paid by the Fund to M&D for its services as the Fund's manager is based upon a percentage of the Fund's net assets, with an incentive adjustment for the Fund's investment performance.

In its role as distributor of the Fund's shares, M&D arranges for the sale of Fund shares to the public through independent securities dealers at a price equal to net asset value plus a sales charge. M&D, under its contract with the Fund, retains less than a quarter of the sales charge and allows the balance to dealers who sell Fund shares (App. A-30).

The defendant F. Eberstadt & Co., Inc. ("Eberstadt"), M&D's parent company, is and has been since 1962 a member firm of the New York Stock Exchange ("NYSE") and a member of the National Association of Securities Dealers ("NASD"). Eberstadt later became a member of the American Stock Exchange as well.

Defendant Robert G. Zeller is Vice Chairman of the Fund's Board of Directors, Vice Chairman of M&D's Board and Chairman of the Board of Eberstadt.

None of the other named defendants was served and the action was dismissed as to them (App. A-84).

B. The Fund's portfolio brokerage practices

Whenever the Fund seeks to purchase or sell securities for its portfolio it is necessary, except in unusual circumstances, to select a broker to execute the transaction or to deal directly with a dealer who owns or wishes to purchase the particular securities being purchased or sold (App. A-33). In selecting brokers for the execution of Fund portfolio transactions, it is a stipulated fact that M&D's primary concern has always been the price and quality of execution to be provided to the Fund (App. A-78, 34). Only when two or more prospective executing brokers could provide equal price and quality of execution were other criteria considered in the selection of brokers. Despite plaintiff's references to "excess commissions", no contention is made, nor could it be, that the Fund ever paid a larger commission than was necessary.

Assuming equal price and quality of execution, the criteria used in selecting an executing broker, until July 15, 1973, were the broker's sales of Fund shares to the public and the usefulness of research and statistical serv-

ices which he provided to the Fund through M&D* (App. A-34). After July 15, 1973, in accordance with a rule adopted by the NASD, a broker's sales of Fund shares was no longer a qualifying or disqualifying factor in the selection of executing brokers. Both Eberstadt and M&D are and have been members of the NASD (App. A-28, 29).

Prior to December 5, 1968, it was common practice for a mutual fund or its manager to direct executing brokers on the NYSE and other national securities exchanges to "give-up" part of their commissions to other exchange members who had sold Fund shares to the public or who had provided useful research or statistical material, but who had not participated in any way in the execution of the transaction on the exchange (App. A-56, 34-35).

Give-ups did not increase fund brokerage costs because the NYSE and other national securities exchanges required their members to charge a fixed minimum commission rate and prohibited direct rebates to customers.** Some brokers, however, were willing to compete for the execution of profitable institutional orders by giving up part of their commissions to other brokers who were members of the exchange, since the costs associated with execution of these orders were not proportionately greater than the cost of executing smaller orders. Until give-ups were abolished by amendments to stock exchange rules on December 5, 1968, the Fund followed the industry practice of directing executing brokers to "give-up" part of their commissions

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* By adroit employment of quotation marks, plaintiff suggests that dealers who sold Fund shares "performed some service *for the management*" (Br. 25, fn; emphasis as in plaintiff's brief). The testimony, however, was that these were services performed for the benefit of the Fund (Tr. 97-98).

** The NYSE Constitution was amended in 1971 to permit the negotiation of commissions on large transactions (App. 352, 356; Ex. E).

to other exchange members who had provided sales, statistical or research services (App. A-55, 56, 57, 58, 34, 35).

While the Constitution and Rules of the NYSE and other national securities exchanges have always prohibited the direct rebate of commissions to customers, the NYSE has permitted member firms who serve as investment advisers to credit against the investment advisory fee some portion of the commissions earned by the member firm for the execution of portfolio transactions for the investment advisory client (App. A-60, 36). Accordingly, the constitution and rules of the NYSE would have permitted M&D to credit against the management fee payable to it by the Fund some portion of any brokerage commissions earned by Eberstadt in the execution of the Fund's portfolio transactions and, prior to the time when give-ups were abolished, some portion of any give-ups received by Eberstadt with respect to Fund brokerage business.

However, the Board of Directors of the Fund consistently directed that Eberstadt *not* act as broker in the execution of Fund portfolio transactions and that it *not* receive give-ups from other brokers in connection with Fund portfolio transactions* (App. A-36, 37). Eberstadt's non-involvement in Fund brokerage has been made clear to the Fund's shareholders in prospectuses and proxy statements (Ex. 11, p. 7; Ex. 12, p. 9; Ex. 13, p. 10; Ex. 14, p. 8; Ex. 15, p. 9; Ex. 16, p. 9; Ex. 17, p. 12; Ex. 18, p. 10; Ex. 19,

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* Approximately 80 percent of the Fund's portfolio transactions have been executed on the NYSE (App. A-33). Considerations of best execution have precluded greater use of the regional stock exchanges. Accordingly, while the rules of regional stock exchanges have permitted various methods of recapture, the use of regional exchanges for this purpose was not a practical or useful course of action for the Fund, consistent with its policy of best price and execution. In any event, in view of Eberstadt's seat on the NYSE, the various regional recapture devices would have been superfluous if the Fund's directors had decided to engage in recapture.

p. 8; Ex. 32, p. 3; Ex. 33, p. 10; Ex. 34, p. 9; Ex. 35, p. 9; Ex. 36, p. 11; Ex. 37, p. 7).

Some other mutual funds, like Chemical Fund, have been managed by firms which are NYSE members or are affiliated with NYSE members. However, no such fund of significant size engaged in the practice of directing give-ups to its manager for recapture purposes. The larger funds in the industry, contrary to plaintiff's assertions, have not, in general, sought to reduce their management fees by recapture devices, except to the extent that some funds have entered into such arrangements in order to settle stockholder litigation in which the plaintiffs charged breach of duty in the failure to recapture (App. 312-313; Tr. 77-79, 83; Ex. 69, p. 1-2; Ex. 114).

C. The repeated exercise of informed business judgment by the Fund's independent directors is incontrovertibly documented by contemporaneous records

The Fund's Board of Directors determined, in the good faith exercise of business judgment and upon the advice of counsel, that it was not in the best interests of the Fund or its shareholders to involve Eberstadt or M&D in the execution of the Fund's brokerage transactions.

The District Court's findings on the business, academic and professional qualifications of the Fund's directors (App. A-53, 54; Tr. 43-49, 156-160, 214-215) demonstrate the directors' unique competence to make the business judgment which plaintiff attacks. Moreover, it is a stipulated fact that a majority of the Fund's directors has been at all times completely independent of Eberstadt and M&D (App. A-53, 29).

When Eberstadt joined the NYSE in 1962, the Fund's directors considered and rejected the idea that Eberstadt

should become involved in the Fund's brokerage business or otherwise serve as a vehicle for recapture. The Board considered this question at least once each year thereafter and always decided against the involvement of Eberstadt in the Fund's brokerage business (Tr. 52-53, 163-165).

The Board's careful consideration of the recapture question is established by incontrovertible documentary proof (App. A-66, 67, 68, 69, 70, 307-351).

1. *The SEC's 1966 "PPI Report"*

On January 9, 1967, M&D sent to the Fund's directors a summary of the SEC's "PPI Report" (App. 307; Ex. 162).* This memorandum told the directors that the "SEC apparently looks with favor on the practice of using brokerage business on portfolio transactions to reduce the cost of management" (App. 312) and noted that brokerage affiliates of two mutual fund organizations had been recapturing commissions on the Pacific Coast Stock Exchange (App. A-66, 313).

2. *The SEC's proposal of Rule 10b-10 in 1968*

After the SEC issued in January, 1968 a release exposing for public comment a proposed new Rule 10b-10 which would have prohibited give-ups with respect to fund portfolio transactions unless the give-up was recaptured, M&D forwarded a copy of the SEC's release to the Fund's directors.**

The proposed Rule 10b-10 was never adopted and was ultimately withdrawn (Tr. 56-57, 168-169; App. 358). The underlying premise of the proposed rule—that recapture

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* Report of the Securities and Exchange Commission on the PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH (1966), H. Rep. No. 2337, 89th Cong., 2d Sess.

** Sec. Exch. Act Release No. 8239 (Jan. 26, 1968) (Ex. 89); [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,523.

was mandatory—was later repudiated by the SEC's General Counsel (App. 358).

On February 20, 1968, the Fund's Board of Directors received and relied upon the opinion of the Fund's counsel concerning the Fund's brokerage practices in light of the SEC release proposing Rule 10b-10 (App. 319, Tr. 168-169). Counsel advised the Board that, assuming the Board had considered all the relevant facts, including the possibility of adopting alternate brokerage methods, and assuming the Board concluded as a matter of reasonable business judgment that it was in the best interests of the Fund and its shareholders to continue the Fund's existing brokerage and give-up practices, then approval of the existing practices would be lawful (App. A-67, 319; Tr. 58-59, 168-169).

3. The 1968 Report to the Board of Directors

On February 21, 1968 a committee of the Fund's Board of Directors consisting of Mr. Dorsett and Dr. Murray, reported in writing to the full Board on the subject of give-ups (App. A-67, 68, 321). Both of these directors, who testified at the trial, were particularly qualified to look into and report to the Board on brokerage practices. Dr. Murray is S. Sloan Colt Professor of Banking and Finance at the Graduate School of Business of Columbia University. He was formerly the officer in charge of investment research and institutional investment management services at Bankers Trust Company (Tr. 155-157). Mr. Dorsett, as Vice President and Senior Investment Officer of College Retirement Equities Fund, manages one of the largest portfolios of equity securities in the United States and formerly managed the investments of the University of Rochester (App. A-53; Tr. 283-284). Both men have had extensive experience in the execution of securities transactions and in the allocation of brokerage business (App. A-54; Tr. 43, 44, 46, 156-159, 283-284).

The subcommittee noted that it was possible for the Fund to recapture commissions on portfolio transactions by directing Eberstadt to execute brokerage transactions or to seek give-ups on Fund brokerage business, but concluded that changing the Fund's practice in this respect was not advisable. Mr. Dorsett and Dr. Murray stated in their report to the unaffiliated directors as follows (App. A-68, 323-324):

> "We quote from the SEC release as follows: 'Many mutual fund managers believe that so long as this type of sales incentive can be given to dealers, competition among mutual fund managers for the favor of dealers will make it difficult, if not impossible, for any individual fund manager to fail to provide such compensation to dealers, both members and nonmembers of exchanges, selling shares of his funds.' We agree completely with this statement. Regardless of the merits of this method of doing business, it is not practical to attempt a change for Chemical Fund at this time even though we recognize that it would be possible to request the manager to execute some portfolio transactions as a member of the New York Stock Exchange or request give-ups on portfolio transactions which would be credited against the amount of the management fee."

4. The 1969 and 1970 Reports to the Board of Directors

The next year, as it did every year thereafter (Ex. 93, 94, 95, 96, 97, A), M&D provided to a committee of unaffiliated directors a complete review of the operations of the Fund and M&D.

In February 1969 and again in January 1970, a Board committee again reviewed the Fund's portfolio brokerage

business and recommended that there be no change in the Fund's practice of not placing orders with Eberstadt and of allocating brokerage first on the basis of best price and execution and, second, on the basis of other services provided by the broker to the Fund (App. A-68-69, 337, 341).

On both occasions, the full Board subsequently voted to continue existing brokerage practices (App. A-69; Ex. 63, p. 4).

5. The reports to the Board of Directors in 1971, 1972, 1973 and 1974

On January 15, 1971, M&D sent to Dr. Murray and Governor Alfred E. Driscoll,† who at that time comprised a committee of unaffiliated directors to review the operations of the Fund, a memorandum discussing several aspects of the Fund's operations (Ex. 95). The memorandum reviewed once more the subject of portfolio brokerage transactions and the possibility of recapturing commissions by placing orders with Eberstadt (Ex. 95, p. 2). The committee subsequently presented its written report to the Board of Directors and made the following statement with respect to allocation of brokerage:

> "We recommend no change at this time in the method of directing brokerage business. Because of the relatively low rate or portfolio turnover (only 12.1 percent in 1970), the volume of commissions paid is small for a fund of Chemical Fund's size (only some $650,000 in 1970). With so many proposals under discussion regarding negotiated commission rates, institutional membership, and

† Governor Driscoll had been Governor of New Jersey, Chairman of the New Jersey Turnpike Authority and the chief executive officer of the Warner-Lambert Company (App. A-54; Tr. 44).

> the possibility of 'unbundling', we believe that it would be inadvisable to alter present arrangements. We recommend, however, that the subject be reviewed promptly in light of any developments during the year." (App. 343-344).

The Board of Directors, after considering the report, made no change in the Fund's brokerage practices (App. A-69; Ex. 69).

Following the decision of the United States Court of Appeals for the First Circuit in *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir. 1971), M&D mailed copies of the decision to each of the Fund's directors (App. A-69; Tr. 104, 170, 221; Ex. 67). At the Fund's Board meeting on June 16, 1971, a committee of independent directors, consisting of Dr. Murray, Governor Driscoll and Dr. Bertrand Fox,* was appointed to review again the Fund's brokerage practices, to consult with the Fund's counsel and to consider the various alternatives available to the Fund. The committee, after consultation with counsel, recommended no change in the Fund's brokerage practices (App. A-69, 70; Tr. 171, 221-223).

On March 27, 1972 and again on January 15, 1973 committees of unaffiliated directors recommended in writing to the full Board that existing methods of brokerage allocation should be continued (App. A-70, 345, 349). The Board of Directors made no change in the Fund's brokerage practices and on each such occasion approved the Fund's management and distribution agreements with M&D (Tr. 171, 221-223).

Finally, the Fund's audit committee met on January 14, 1974 to consider renewal of the Fund's management and

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* Dr. Fox, who testified at the trial, recently retired as Jacob H. Schiff professor of investment banking at Harvard University Business School (Tr. 214).

distribution agreements with M&D. The committee recommended that "the policy should be continued of having no Fund brokerage business done with [Eberstadt] even though a recapture of a portion of the profits on such brokerage might be possible" (App. A-70; Ex. 78, p. 2).

D. The Fund's charter leaves the allocation of brokerage to the business judgment of the Board of Directors

To confirm and make unquestionably explicit the directors' power to establish the Fund's policies concerning Fund brokerage practices and to direct that brokerage be allocated to brokers who sold Fund shares or who provided research services, the Fund's shareholders approved on March 14, 1972 an amendment to the Fund's certificate of incorporation (App. A-71; Ex. 139, p. 6). This amendment confirmed the power of the directors:

> "8. *To determine in their discretion the manner and purposes of the allocation of brokerage commissions to be paid by the Fund and the selection of the brokers and dealers that shall receive or share directly or indirectly in any such commissions and the basis of such receiving or sharing therein, including, but not limited to, sales of shares of the Fund and any other funds having the same investment adviser and statistical and other information and wire and other services provided to the Fund or the Manager.*"

The proxy statement distributed to Fund shareholders in connection with this meeting described the Fund's brokerage policies as follows (App. 296):

> "The purpose of the above amendment is to make explicit that which has always been implicit, namely,

that the Board of Directors of the Fund (more than 50% of whom are otherwise unaffiliated with the Fund or its Manager) has the power to determine how the portfolio brokerage of the Fund shall be used. In the opinion of the Board of Directors of the Fund, it is in the best interest of the Fund to continue the brokerage practices which it has followed since inception under which all portfolio transactions have been carried out by brokers who are not affiliated with the Manager and Distributor of the Fund and not to make any provision for recapture through an affiliated broker of any part of the brokerage commissions paid by the Fund.

"Accordingly, as reflected in the proposed new Management Agreement discussed below, the Board of Directors has directed the Manager not to have the Fund purchase or sell any portfolio securities through the firm of F. Eberstadt & Co., Inc., the parent of the Manager, which is a member of the New York and American Stock Exchanges. As indicated under 'Allocation of Portfolio Brokerage and Portfolio Turnover Rate' below in this proxy statement, the Fund's Board of Directors and the Manager consider that, subject to obtaining the best price, execution and commission, allocation of brokerage to dealers who have sold shares of the Fund or have provided statistical and research information has been and presently continues to be of benefit to the Fund and its shareholders. The Fund's Manager has been authorized by the Board of Directors to select in the Manager's discretion the brokers or dealers that shall execute portfolio transactions or share directly or indirectly in commissions with respect thereto, and to determine the basis of such

sharing, subject in each case to obtaining the best execution taking into consideration, among other things, price (including any brokerage commission), size of the transaction and need for speed in execution. The Board, of course, would have the right to determine in the future that some other course of action might be desirable." (App. A-31, 32).

ARGUMENT

Summary of Argument

The false assumption which permeates plaintiff's brief is that only by recapture could Fund brokerage commissions be used for the benefit of the Fund. That assumption is not supported by a shred of evidence. Indeed the evidence confirms the wisdom of the Fund's Board of Directors in concluding—in the informed exercise of independent business judgment—that the long-term best interests of the Fund's shareholders were better served by allocating Fund brokerage business to encourage the sale of Fund shares and the flow of useful research and statistical information.

In prohibiting recapture, even though it might result in some relatively modest reduction of the Fund's management fee, the Fund's directors had very much in mind that the use of brokerage commissions to encourage sales and the flow of useful research information was a widespread practice in the mutual fund industry. For Chemical Fund alone to do otherwise would have been competitively disastrous.

It was likewise important to the directors that the Fund, Eberstadt and M&D would face intolerable conflicts of

interest if Eberstadt were required to execute the Fund's portfolio stock brokerage business or to receive give-ups from other brokers. What plaintiff refuses to comprehend is that, as the Fund's Board of Directors concluded, such conflicts of interest would have seriously jeopardized the Fund's business image, impeded the ability of the Fund to sell its shares and affected adversely in other ways the best interests of the Fund's shareholders.

Moreover, the SEC's "PPI Report" in 1966, proposed legislation and other regulatory proposals made it apparent to the Fund's directors that basic changes were imminent in the structure of the securities industry, such as negotiated commissions, divorce of the brokerage and money-management functions and institutional access to the Stock Exchange floor. Many of these proposals would have made recapture impossible—as plaintiffs agree is now the case. Indeed, one such proposal has now been enacted into law as Section 6 of the Securities Acts Amendments of 1975 (Pub. L. 94-29).

It made no sense for the Fund's directors to abandon a long-standing brokerage policy which in their judgment had contributed over the long-term to the Fund's success in favor of a radically different course whose supposed benefits would probably prove to be as short-lived as they were illusory.

Plaintiff's claims purport to be based upon a decision by the First Circuit, *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir. 1971). Analysis of that decision demonstrates that it is not applicable to the entirely different facts of this case. The critical facts which distinguished this case from *Moses* are that here all of the conduct which plaintiff attacks was the result of an informed, good faith exercise of business judgment by the Fund's Board of Directors, a majority of

whom were at all times independent of Eberstadt and M&D.

In arguing that the allocation of brokerage to encourage the sale of Fund's shares and the flow of useful research information violated the management and distribution contracts between the Fund and M&D, plaintiff can point to no specific provision of either contract which prohibited such conduct. No such provision exists. The uncontradicted evidence is that both contracts were negotiated in the context of an industry-wide practice. As the parties to the contract testified at the trial, had recapture or any other change in practice resulted in a significant increase in M&D's costs, both parties would have been required to consider renegotiation of the contracts.

Disclosure of Fund brokerage practices in Fund prospectuses and proxy statements was, as the District Court found, entirely adequate. Plaintiff's arguments in this respect are mere afterthought, for even though the brokerage practices attacked on this appeal were specifically alleged in the complaint, there is no claim asserted in the complaint of inadequate disclosure to Fund shareholders. Similarly, no such contention was listed by plaintiff in the pretrial order. Moreover, it is difficult to perceive how plaintiff can complain derivatively on behalf of the Fund that the Fund was damaged by the falsity of its own prospectuses and proxy statements.

I. Rejection of recapture by the Fund's Board of Directors was a valid exercise of an informed and independent business judgment

As the District Court found, it was a combination and interplay of numerous considerations which influenced the Fund's Board of Directors to establish the policy of not in-

volving Eberstadt or M&D, directly or indirectly, in the Fund's portfolio brokerage business.

While individual officers and directors of the Fund might articulate and rank differently the various considerations involved, the basic reasons for not involving Eberstadt in the Fund's brokerage business were that it would result in intolerable conflicts of interest, create an appearance of conflict of interest, adversely affect the sale of Fund shares and impede the flow of useful research information from securities dealers who were accustomed to receiving Fund brokerage business. These adverse consequences were anticipated by the Fund's directors without regard to the form of rebate device which might be selected and without regard to whether Eberstadt acted as executing broker for the Fund or received give-ups from other brokers on Fund business.

A. Plaintiff cannot prevail no matter what is the legal standard by which defendants' conduct is judged

Plaintiff does not identify with precision the legal standard or body of law under which the defendants' conduct is to be judged.

Perhaps this failure to come to grips with the threshold legal question signals plaintiff's perception of the dilemma which confronts her. If she relies upon the Investment Company Act of 1940, as amended in 1970, the only statutory provision which could be considered conceivably applicable is section 36(a), 15 U.S.C. § 80a-35(a). As we demonstrate below, to the extent that plaintiff rests her case upon section 36(a), she clearly has failed to carry the burden which the statute imposes upon her.

If, on the other hand, plaintiff relies upon the doctrine of pendent jurisdiction so as to bring into play the common

law of New York or Delaware, h r case founders on the business judgment rule. Admittedly, a majority of the Fund's Board o rectors was completely independent (App. A-53, 29) and there is abundant support for the District Court's finding that the directors' repeated rejection of recapture was an informed exercise of good-faith business judgment.

1. The 1970 amendments to the Investment Company Act

Section 36 of the Investment Company Act of 1940, as amended in 1970 (15 U.S.C. § 80a-35(a)), consists of separate paragraphs (a) and (b). Paragraph (a) became effective when the 1970 A endments Act was enacted into law on December 14, 1970 (b. L. 91-547, § 20; 84 Stat. 1428). However, paragraph (b) of Section 36 did not become effective until 18 months later (Pub. L. 91-547, § 30; 84 Stat. 1436). Accordingly, since this action was commenced on May 11, 1971 (App. A-1), prior to the effective date of Section 36(b), plaintiff must necessarily rely solely on Se ion 36(a).

Prior to the 1970 amendments, section 36 authorized the SEC to bring actions against mutual fund officers, directors, investment advisers and certain others for "gross misconduct or gross abuse of trust". While section 36 on its face authorized suit only by the SEC, the courts generally, as in *Moses*, implied a private right of action. *See Tanzer* v. *Huffines*, 314 F. Supp. 189, 193 (D. Del. 1970); *Brown* v. *Bullock*, 194 F. Supp. 207, 245 (S.D.N.Y. 1961), *aff'd*, 294 F.2d 415 (2d Cir. 1961).*

In amending section 36 in 1970, the Congress prescribed a new standard for suits brought by the SEC. Now, as provided in section 36(a), the SEC may bring suit against

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* For the convenience of the Court, we reproduce as an Addendum to this brief the original and amended versions of § 36.

certain investment company affiliates if they have engaged in "any act or practice constituting a breach of fiduciary duty involving personal misconduct" At the same time, the Congress added a new paragraph (b) to section 36 which *explicitly* creates a private right of action—in carefully limited circumstances—for "breach of fiduciary duty in respect of" compensation paid by an investment company to its investment adviser or certain others. As previously noted, section 36(b) is not applicable here.

We turn now to the legal standard which would be applicable to this case if we assume *arguendo* that plaintiff may sue under section 36(a) even though that section speaks in plain terms only of suit by the SEC.*

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* As held in *Monheit* v. *Carter,* 376 F. Supp. 334, 342 (S.D.N.Y. 1974), section 36(a) does not authorize a private right of action. Section 36(a) provides only that "[t]he Commission is authorized to bring an action . . ." and says nothing about a private action. Private actions are provided for only in section 36(b). As the Court said in *Monheit* v. *Carter,* "Section 36(a), however, authorizes an action by the SEC, not by private individuals." *Id.,* at 342.

While a private right of action was implied by the courts under the original section 36, the framework of the pre-1970 statute was very different from the present statute. Unlike the present section 36(b), the prior statute was wholly silent on the subject of private actions, so that there was more room for implication. There would no longer seem to be any basis for reading a private right of action into section 36(a) where Congress provided for none and where Congress instead expressly granted private litigants their remedy in the very next paragraph of the statute.

Both the Senate and House reports on the 1970 amendments contain the statement that "[a]lthough section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a), the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a)." Report of the Committee on Banking and Currency, Senate Report No. 91-184 (1969), p. 16; Report of the Committee on Interstate and Foreign Commerce, House Report No. 91-1382 (1970), p. 38. However, the language of the statute is sufficiently clear that little light is shed by the committee reports.

B. Plaintiff has not carried the burden of proof imposed by section 36(a) of the Investment Company Act

Section 36(a) of the Investment Company Act, as amended in 1970, requires proof of "breach of fiduciary duty *involving personal misconduct*" [emphasis added]. When section 36(a) and section 36(b) are read together, it is readily apparent that section 36(a)'s requirement of "personal misconduct" is central to the statutory scheme.

Section 36(b) specifically provides a private right of action for "breach of fiduciary duty" in respect of an investment adviser's "receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser."

However, the section specifically provides in subparagraph (1) that in a private action brought under section 36(b), "It shall not be necessary to allege or prove that any defendant engaged in personal misconduct". The section provides further in subparagraph (2) that private actions under section 36(b) may be brought *only* against the recipient of the allegedly excessive compensation, that recovery may not exceed the amount received and that, in any event, damages are not recoverable for any period prior to one year before the private action was instituted.

Thus the central distinguishing feature between section 36(a) and section 36(b) is plaintiff's burden of proving "personal misconduct" in any action predicated upon section 36(a). Otherwise, to the extent that section 36(a) permits the implication of a private right of action, section 36(b) would be subsumed in its entirety by section 36(a) and would be rendered entirely meaningless. *Cf. Blue Chip*

Stamps v. *Manor Drug Stores*, 421 U.S. 723, 735-736 (1975). Moreover, the limitations which the Congress prescribed for private actions brought under section 36(b) would be rendered futile and meaningless if plaintiffs who sued under section 36(a) wer not required to prove genuine "personal misconduct" by a preponderance of the evidence.

This is confirmed by the legislative history of the 1970 amendments. The committee reports in both houses of the Congress stress that section 36(a) "is intended to deal only with such violations committed by individuals" and was not intended to reach industry practices which the SEC considered questionable.

As the committee reports state:

> "This section is intended to deal only with such violations committed by individuals. It is not intended to provide a basis for the Commission to undertake a general revision of the practices or structures of the investment company industry." Report of the Committee on Banking and Currency, Senate Report No. 91-184 (1969), p. 36; Report of the Committee on Interstate and Foreign Commerce, House Report No. 91-1832 (1970), p. 37.

Nothing in the trial record here could conceivably support a finding that any officer or director of the Fund or anyone associated in any capacity with Eberstadt or M&D was guilty of "personal misconduct". Even if plaintiff were right in her contention that recapture was mandatory as a matter of law, the worst that could be said against any of the individuals involved is that while they acted honestly, in perfect good faith and in reliance upon the advice of counsel, they erred in concluding that recapture was not in

the best interests of the Fund and its shareholders. Certainly, that cannot be said to be "personal misconduct".

Moreover, the only individual defendant here is Mr. Zeller and nothing in the record affords the slightest basis for any determination that he was guilty of "personal misconduct". Certainly the District Court could not have made a determination of "personal misconduct" by any person who did not have an opportunity to defend himself because he was not named as a defendant or served with process in this litigation.

C. Recapture would involve the Fund in intolerable conflicts of interest in fact and in appearance

As the District Court found, the Fund's directors were convinced that any involvement of Eberstadt in the Fund's brokerage business would create a conflict of interest and, perhaps of equal importance, the appearance of conflict of interest in the eyes of Fund shareholders and the investment community (App. A-81, 82; Tr. 33, 64, 175, 218-219).

If Eberstadt became involved in the Fund's brokerage business, it might appear to Fund shareholders and others (whether or not justifiably) that M&D's investment recommendations to the Fund were motivated by a desire to generate commissions. The appearance of a conflict of interest by involvement of Eberstadt in the Fund's brokerage would affect adversely the Fund's image and the sale of its shares (Tr. 69-70). As Dr. Murray testified:

> "Now, if the commission business were put through F. Eberstadt & Company there would always be in the minds of investors or potential investors or the public to which the shares were offered the suspicion, no matter how unwarranted, that now there would be an increase in turnover, that there would be churning of the portfolio in order to gen-

erate an enlarged volume of commission business." (Tr. 175).

Dr. Fox felt just as strongly:

"Probably the most important reason in my mind was that I thought that all investment decisions should be made for the Fund without any possibility of being influenced by the possibility of obtaining additional brokerage revenue. I wanted a complete separation of the investment function and the brokerage function. I wanted no possibility of being accused or of the Fund being accused of churning the portfolio to generate additional brokerage. And although it is my strong belief that the officers of the Fund have the same view in this respect I wanted to make sure that there was no possibility of it and that the public understood that there was no possibility of it, so the reputation of the Fund would be clear in this respect." (Tr. 218-219)

It was the fear of all concerned that an omnipresent appearance of conflict of interest would distort the focus of the Board of Directors when they reviewed M&D's investment recommendations. As Mr. Zeller testified:

". . . when the staff comes to the Portfolio Committee with a recommendation that a certain security be sold and another security purchased, there has never been implicit in that a concern in the independent directors' minds as to whether we are doing this just to generate brokerage, and it is very important to me that there never be such a concern." (Tr. 46)

The potential for "debilitating" effect was obvious to all (Tr. 241).

Since the very reason for the Fund's existence is the profitable investment of its shareholders' savings, it would be foolhardy—and indeed irresponsible—to embark upon a recapture program for the purpose of a relatively modest saving in the management fee when the directors believed that such a course would impede portfolio management.

So pervasive was the potential for conflict of interest that it would extend beyond investment decision-making and would affect as well the Fund's trading desk.

Eberstadt acts as broker for institutions and individuals. If it acted also as broker for the Fund, it would inevitably be called upon to buy or sell simultaneously the same securities for the Fund and for other clients. This would necessarily involve Eberstadt in a conflict of interest in its execution responsibilities to the Fund and other clients (Tr. 171-172).

The Fund's directors recognized the desirability of dealing at "arm's length" (Tr. 185) with a broker who is not affiliated with the Fund rather than permitting or, indeed, requiring Eberstadt to participate "on both sides of a transaction" where "there is almost inevitably a conflict" (Tr. 61-64). "Best execution" requires an "adversary" relationship between the Fund and its broker. This would be missing, and would appear to be missing, if the Fund used Eberstadt as its broker (Tr. 64, 172).

Moreover, some of the directors were not satisfied that best execution could invariably be obtained by using Eberstadt as the Fund's broker (Tr. 219, 248, 253). Further, the relative execution capabilities of Eberstadt and other brokers and the degree of willingness of various brokers to pay give-ups were sore points of conflict which the directors sought to avoid. The Fund trading desk is staffed by M&D employees and no realistic assessment of human nature

could assume that M&D employees at the Fund trading desk would find it easy to conclude, in their search for best execution, that Eberstadt's competitors were more competent brokers.

Finally, the consistent use of Eberstadt rather than a variety of other brokers for the execution of Fund portfolio transactions might enable members of the financial community to identify the Fund as a buyer or seller and thus anticipate, to the detriment of the Fund and its shareholders, the implementation of Fund investment decisions (Tr. 173).

D. Recapture would have an adverse impact on the sale of Fund shares

Another factor in the directors' decision not to involve Eberstadt in the Fund's brokerage business was the competitive necessity of allocating brokerage and give-ups to brokers who sold Fund shares (App. 321; Tr. 77, 174). So long as other funds were stimulating the sale of fund shares by the allocation of brokerage and give-ups, Chemical Fund was as a practical matter required to do likewise (App. 323-4).

The continuous sale of Fund shares is in the best interests of the Fund and its shareholders, since a continuous flow of new money is essential for effective portfolio management (Tr. 71, 174, 178-180). Moreover, since Fund shares are being continuously redeemed, the directors considered it imperative that sales be at least great enough to offset redemptions; otherwise, portfolio securities would have to be sold, regardless of investment considerations, to meet redemptions (App. 341; Tr. 19, 71, 123). In addition, because of economies of scale and the Fund's tapered management fee, which decreases as a percentage of Fund assets

as the size of the Fund increases, growth of the Fund through sales tends to reduce management costs per dollar of Fund assets (Tr. 70-71, 179).

While the Fund's superior investment performance (App. A-77; Tr. 22-28; Ex. K) has been an important factor in the sale of Fund shares, securities dealers who hope to receive brokerage business from the Fund would be less likely to recommend the purchase of Fund shares as opposed to other funds if they understood that substantially all of the Fund's brokerage business was to be allocated to Eberstadt for recapture purposes (Tr. 64-65, 69-70, 174, 219).

It was for the Fund's directors to determine, as a matter of business judgment, whether the shareholders would be better served in the long run by using brokerage and give-ups to stimulate sales or by gobbling it up for recapture. Nothing in the trial record could support a speculation that the Fund's superior investment and sales performance (Ex. L, Tr. 28-30) could have been achieved if brokerage and give-ups had been allocated to recapture rather than to dealers who sold Fund shares.

E. It was in the best interests of the Fund's shareholders to allocate brokerage to dealers who furnished useful research information

The Fund has followed the industry practice of allocating brokerage business and give-ups to securities dealers who provide research and statistical information to M&D for the benefit of the Fund. The research material which M&D receives from brokers serves to supplement and confirm M&D's own research and to provide ideas about particular industries and particular companies so that M&D can then conduct its own investigation. In this sense, the research provided by independent brokers does not reduce M&D's operating costs (Tr. 34, 37, 212-213).

The directors have always considered allocation of brokerage for that purpose to be in the best interests of the Fund and its shareholders (Tr. 173-174, 195, 219; App. 341).* As a practical matter, in the structure of the securities industry as it existed during the period between 1965 and the time of trial, there appears to have been no way to obtain such information except by the allocation of brokerage (Tr. 64-65, 101-102).

Moreover, the SEC has recognized the appropriateness and desirability of allocating mutual fund brokerage for research. Thus, "the Commission believes that an investment manager should have discretion, in assigning an execution . . . to consider the full range and quality of a broker's services which benefit the account under management." **

The desirability and usefulness of allocating brokerage for research is demonstrated by the Securities Acts Amendments of 1975 (Pub. L. 94-29), which adds section 28(e)(1) to the Securities Exchange Act of 1934. The new section provides, in essence, that a mutual fund manager (and other fiduciaries) may pay *higher* commissions than those necessary for execution in order to reward brokers who have provided useful research services.*** The Fund's allocation of portfolio brokerage commissions to brokers who provided research information is, therefore, wholly con-

* See, for example, the January 22, 1970 report of the committee of unaffiliated directors reviewing the Fund's management agreement with M&D, where the subcommittee recommended "that [M&D] give consideration to the allocation of a larger volume of commissions for investment research, particularly during the current broadening of the interscience concept of investment media" (App. 341).

** Investment Company Act Release No. 7170, May 9, 1972; [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,776.

*** It is stipulated in this case, however, that the Fund always sought best execution and the lowest rate of commission (App. A-34).

sistent with public policy as later enunciated by the Congress and is, indeed, a practice which the Congress seeks to encourage.

F. Imminent changes in the structure of the securities industry made it unwise to change the Fund's brokerage policies

The Fund's Board of Directors was aware of the numerous proposals which have been made in recent years to restructure the brokerage industry (Tr. 72-74, 172-173, 176-177, 222-224). Some of the changes were on the horizon at least as early as 1969 (App. 358; Tr. 73). A committee of unaffiliated directors therefore recommended that no change be made in the Fund's brokerage practices until the probable direction of industry change could be determined (App. 344).

For example, the "Martin Report" published by the NYSE in 1971 recommended that NYSE member firms be required to divest themselves of subsidiaries which manage mutual funds (Ex. M, p. 17; Tr. 177, 220-221). If this proposal were ever implemented, Eberstadt would have been required to divest itself of M&D and, as a result, there would no longer be any way in which the Fund could use Eberstadt as its broker for the purpose of recapturing commissions.

In May, 1975 Congress did indeed enact legislation (which had been first proposed many years earlier; Tr. 220, 223-4) to divorce the brokerage and investment advisory functions of members of national securities exchanges. (Securities Acts Amendments of 1975 (Pub. L. 94-29), § 6). It did so by amending Section 11(a)(1) of the Securities Exchange Act of 1934 to provide, in pertinent part, that "it shall be unlawful for any member of a national securities exchange to effect any transaction on such exchange for . . . an account with respect to which it or an associated person thereof

exercises investment discretion". Any arrangement by which Eberstadt used its stock exchange membership to execute any portion of the Fund's brokerage transactions would fall squarely within the prohibition of the Act.

Also significant was the SEC's earlier adoption of Rule 19b-2, which restricted the ability of stock exchange members to execute brokerage transactions for affiliated or managed accounts.*

Similarly, the Board of Governors of the NYSE has on several occasions proposed an amendment to NYSE rules which would prohibit reduction of investment advisory fees by the offset of brokerage commissions (Tr. 73-74).

So long as proposals such as these were receiving serious consideration in the Congress and by regulatory agencies, it made no sense for the Fund to substitute for a policy which had operated successfully for many years a radically different course of business whose longevity was as questionable as its wisdom.**

In addition, stock exchange commissions have been negotiable on large transactions since 1971.*** The advent of

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* Sec. Exch. Act Release No. 9950 (Jan. 16, 1973); [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,178. The rule was repealed following the 1975 amendments to the Securities Exchange Act of 1934.

** In January 1972, the SEC staff refused to issue a "no-action" letter, its customary form of acquiescence, to a fund which planned to commence recapturing brokerage commissions through an affiliated broker. The staff noted that the SEC was "considering the problem of institutional access to national security exchanges" and stated that "because of this factor . . . the manager, [the affiliated broker] and the fund will be acting at their own risk if they proceed with the proposed arrangement." *Allstate Enterprises Stock Fund, Inc.*, Jan. 29, 1972.

*** All commissions have been negotiable since May 1, 1975. See Sec. Exch. Act Release No. 11,203, Jan. 23, 1975; 1975 CCH Fed. Sec. L. Rep. ¶ 80,067.

negotiated commissions was anticipated long before 1971 (Tr. 72-73, 176-177). If Eberstadt were required to negotiate commission rates with its subsidiary M&D on Fund portfolio transactions, there would be intolerable conflicts of interest several times each business day.

G. The reasons for not recapturing were equally applicable to the use of Eberstadt as a conduit for give-ups

For present purposes there is no distinction between the execution of Fund brokerage transactions by Eberstadt and give-ups, for the latter were simply a device for achieving indirectly what the Fund's directors had concluded should not be done.

Certainly there can be no distinction for the purposes of this case between the allocation of give-ups and the allocation of brokerage orders to securities dealers who sold Fund shares or who provided useful research information. In either event, so long as competing funds followed either practice, Chemical Fund had no alternative but to do likewise. The sale of Fund shares would be adversely affected just as much by the diversion of give-ups to Eberstadt as by the allocation to Eberstadt of orders for execution.

Similarly, the flow of useful research information to M&D for the benefit of the Fund would dry up just as much from the diversion of give-ups as by the allocation to Eberstadt of brokerage orders which formerly were given to securities dealers who had been helpful in this respect.

We have already demonstrated and will not repeat here the importance to the Fund of a continuous and successful sales effort. The directors wisely concluded that the relatively modest and temporary monetary benefits of recapture were outweighed by the importance of sales and by the con-

tinuous flow of useful research information which could be helpful to the Fund's investment performance (Tr. 130-131; see Tr. 119-120).

The diversion of give-ups to Eberstadt posed problems of conflict of interest which differed only in degree from those involved in Eberstadt's acting as an executing broker. The fact that the give-up was a piece of gimmickry designed to circumvent the NYSE's anti-rebate rule was in itself good reason for wariness. To explain the gimmick to the Fund's shareholders was a task which bordered upon the impossible (Tr. 197-198a).

As Dr. Murray testified, all but the most sophisticated and marketwise among the Fund's shareholders would probably suspect, despite the most lucid explanation of an inherently improbable device, that somehow, some way some piece of the give-up was sticking to Eberstadt's palm (Tr. 197-198a). Certainly the image of the Fund would not be burnished by the practice. The "breach in the wall" (Tr. 68) which plaintiff espouses would have clouded the Fund's image as a company which conducted its business in such a manner as to be beyond reproach. That reputation was an asset of the Fund which the directors were obligated to protect.

II. The *Moses* decision is not applicable to this case

Plaintiff's argument for requiring recapture seems to rest almost entirely upon a few paragraphs of *dicta* in the lengthy opinion in *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir. 1971). In fact, the case offers only superficial support for plaintiff's position.

Indeed, after noting that "a change from independent brokerage to an affiliated broker is not a matter to be

lightly undertaken" (p. 374), the Court held that it would not question or interfere with the business judgment of the fund's directors that fund portfolio transactions should not be executed through an affiliated broker.

The Court likewise rejected plaintiff's contention that it was unlawful to allocate "reciprocal" brokerage business to unaffiliated brokers "in proportion to their success in selling Fund shares to the public." (p. 372, n. 5).

In *Moses,* the Court held Fidelity Fund's manager liable for its failure to seek recapture of the commissions paid by the fund for transactions executed on two regional stock exchanges. The Court held that recapture was available on those exchanges by reason of the NASD membership of the fund's distributor and principal underwriter, which was a subsidiary of the manager. The predicate for liability—and the sole predicate for liability—was the manager's willful and deliberate failure to inform the fund's unaffiliated directors that recapture was available, so that the directors never had the opportunity to exercise their business judgment on whether recapture should or should not be pursued.*

As the Court stated (p. 384):

> "Enough has been said to show that Management defendants were not guilty of mere negligence. They knew, seemingly in June 1965, and at least after the publication of PPI, that the possibility of recapture was a serious and unresolved issue in the industry. They also knew that it was an issue that involved

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* See *White* v. *Auerbach,* CCH Fed. Sec. L. Rep. ¶ 93,617, at p. 92,828, which interpreted the holding of *Moses* as relating solely to liability for nondisclosure to unaffiliated directors. See also the characterization of *Moses* in *Schlusselberg* v. *Keystone Cus-*

(continued next page)

a potential conflict between their interests and the interests of Fund's shareholders. Their failure to disclose the information available to them to the unaffiliated directors was the result of neither inadvertence nor misapprehension of the facts."

The Court held that the time period for which the defendants were liable should be triggered by the SEC's PPI Report of December, 1966 and the defendants' subsequent failure adequately to disclose to the unaffiliated directors some of the suggestions of recapture possibilities which were contained in the report. "We hold, as a matter of law, in view of the PPI report, that this date can no later than March 1, 1967." 445 F.2d at 385.

Here, of course, the facts are entirely different. For example, the PPI Report was specifically called to the attention of the Chemical Fund Board of Directors promptly after its publication. M&D specifically advised the directors of the possibilities of recapture discussed in the report (App. 313) and further advised the directors that the "SEC apparently looks with favor on the practice of using brokerage business on portfolio transactions to reduce the costs of management" (App. 312). As shown

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todian Funds, Inc., CCH Fed. Sec. L. Rep. ¶ 93,901 at p. 93,613 (S.D.N.Y. 1973):

"Plaintiffs' claim for improper brokerage practices concededly rests on the authority of *Moses* v. *Burgin*, which imposed liability on an investment advisor for failure to warn the mutual fund of money saving devices available in certain stock markets. The applicability of *Moses* here is questionable because of the particular stock markets involved and because the discovery has revealed that defendants have a good chance of showing that the investment advisors did warn the mutual funds of the opportunities to avail themselves of money saving devices, but that the directors, in their best judgment, decided not to use them." (citation omitted)

earlier, the Fund's unaffiliated directors periodically considered the whole question and exercised their best business judgment. In *Moses* no such business judgment was or could have been exercised because the unaffiliated directors had not been advised of the various recapture possibilities.

A. The *Moses* "net asset value" *dicta*

The *Moses dicta** upon which plaintiff seems to rest her case suggests that the Fund's certificate of incorporation, in providing that Fund shares may not be sold for less than their net asset value, required recapture. The relevant paragraph from the Court's opinion reads as follows (445 F.2d, at 374):

> "Fund's charter required that upon sale of its shares it receive their full asset value. The obvious purpose was to prevent the value of the existing shareholders' interest in the assets from being diminished by the addition of further participants. If Fund receives the asset value of new shares, but at the same time rewards the selling broker with give-ups that it has a right to recapture for itself, then the net income Fund receives from the process of selling a share is less than asset value. The existing shareholders have contributed—by paying more than otherwise necessary on Fund's portfolio transactions—to the cost of the sale, which was supposed to have been borne by the new member alone. We cannot, therefore, consider absolving the defendants, if we

* Since *Moses* was a case of non-disclosure of relevant information to Fund directors, the quoted paragraph is plainly *dicta*. In fact one commentator has said that the "exact role of the charter argument is actually rather mystifying" and suggested that it might be either "superfluous" or "irrelevant". Duke Law J., *op. cit.*, 460, n. 188.

find that they have violated any duty owed the Fund, by finding that directing give-ups to brokers benefitted Fund by stimulating sales of its shares. Such application violated its charter if it would have been practicable to obtain the give-ups for the direct benefit of its treasury."

We respectfully submit that these *dicta* concerning the calculation of "net asset value" are wrong and are predicated upon a misconception of how a fund's net asset value is calculated.

We note at the outset that the *Moses* decision was questioned by Judge Wyatt in *Fogel* v. *Chestnutt,* 383 F. Supp. 914, at 921 (S.D.N.Y. 1974), and by several commentators: "[T]he development of the *Moses* decision is occasionally uncertain and its reasoning is not uniformly tight"; "The rather scattered nature of the *Moses* opinion has been commented on elsewhere. See Lipton . . . ('a very poorly reasoned opinion')." *Comment, Mutual Funds and Independent Directors: Can Moses Lead to Better Business Judgment?* 1972 Duke L. J., 429, 459 (1972) (text and note 183). See Lipton, 4 Rev. Sec. Reg. 853, 856, n. 23. Judge Carter was clearly right in his observation that "non-disclosure is the only precedential value that *Burgin* now retains." (App. A-65)

The Fund's certificate of incorporation contains a provision similar to the charter provision referred to in *Moses,* and mutual fund charters universally provide that shares may not be sold for less than their net asset value. Charter provisions such as these, however, are generally irrelevant to the question of recapture because, without regard to charter provisions, the Investment Company Act and the rules of the SEC require, clearly and specifically, that

mutual fund shares may not be sold for less than their net asset value.

A mutual fund is, by statutory definition, a company which offers "redeemable" securities for sale (§ 5(a)(1), 15 U.S.C. §80a-5). A redeemable security, by statutory definition, is one which entitles its holder to receive "his proportionate share of the issuer's current net assets" (§ 2(a)(32), 15 U.S.C. § 80a-2(a)(32)).

The SEC has implemented these statutory provisions by regulations which require that no mutual fund may sell or redeem its securities except at current net asset value, which is required to be computed on each day during which the New York Stock Exchange is open for trading (17 C.F.R. § 270.22c-1, 3 CCH Fed. Sec. L. Rep. ¶ 48,762). Another SEC rule specifies the manner in which current net asset value is to be calculated (17 C.F.R. § 270.2a-4), 3 CCH Fed. Sec. L. Rep. ¶ 47,250).

However, no one— not even the Court in *Moses* v. *Burgin* —has ever suggested that the Investment Company Act, in requiring that Fund shares be sold and redeemed only at current net asset value, requires recapture as a matter of law. It should be conclusive on this point that the SEC has known for many years that, while a few investment companies sought recapture of portions of commissions paid on regional stock exchanges, most mutual funds did not. (PPI Report p. 173, n.82). Yet, despite volumes of discussion on the subject by the SEC and its staff, the SEC has never contended that the statutory provisions with respect to net asset value required recapture as a matter of law.

The error of the *Moses* dicta becomes apparent when one considers it in relation to two releases by the SEC. As previously noted, the SEC proposed for comment in 1968 a rule which would have made the recapture of give-ups

mandatory.* The proposed rule was accompanied by a lengthy discussion of give-ups and fund brokerage practices generally. Nowhere is there any discussion which suggests that fund charters or the SEC rules with respect to the calculation of net asset value required the recapture of give-ups. In fact, if the *Moses* dicta were correct, there would have been no need for the proposed Rule 10b-10 and the discussion contained in the release would have been wholly irrelevant.

The second SEC release which is relevant here was issued in 1969, after the SEC withdrew its proposed Rule 10b-10. In that release (App. 358)** the Commission published the opinion of its General Counsel that there was no fiduciary duty to recapture brokerage commissions through the acquisition of a stock exchange seat and that this was entirely a matter of business judgment. As the General Counsel said:

> "You first ask whether mutual fund management has a fiduciary duty to acquire a stock-exchange seat, directly or through an affiliate, in order to utilize this means to recapture brokerage which in turn will be offset against management charges. We do not believe that management has this duty if in the exercise of its best business judgment management determines that it is not in the best interest of the fund to create such an affiliate."

The Commission's General Counsel ruled also, by clear implication, that even if a fund manager played no part in the execution of fund portfolio transactions but merely utilized a stock exchange membership to receive money

* Sec. Exch. Act Release No. 8239 (Jan. 26, 1968) (Ex. 89); [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,523.

** [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,761.

from executing brokers, there may be circumstances in which the fund manager could keep these "give-ups" for itself. As the General Counsel said:

> "It should be understood, however, that if mutual fund management does acquire a seat on a regional stock exchange whose rules permit the recapture of commissions paid by the fund through the use of that seat, *there may be circumstances under which such recapture could be required* and that the management may not be free to simply retain for itself revenues derived from this source. This is particularly likely to be true where the affiliate on the exchange does not execute or clear transactions for the account of the fund, but merely receives revenue from other brokers, which revenue is attributable to transactions executed for the account of the fund by such other brokers." (emphasis supplied)

B. Even if the Fund recaptured *all* of its brokerage commissions, there would have been no effect upon net asset value

As previously noted, an SEC rule (C.F.R. § 270.2a-4) provides specifically for the manner in which daily net asset value is to be computed. The daily computation of the net asset value of each Fund share was made in accordance with that SEC Rule (Tr. 142, 144) and in accordance with generally accepted accounting practices (Tr. 145).

The SEC rule provides that all items of expense, including management fees (whether or not offset by recapture), and income must be included in the computation. However, the rule provides in subparagraph (b) that such items of income and expense need not be reflected in the daily calculation of net asset value if "cumulatively when netted

they do not amount to as much as one cent per outstanding share." (see Tr. 147-148)

If the Fund had engaged in recapture, the recaptured commissions would have been offset against the management fees paid by the Fund.

In calculating net asset value, the Fund accrues the management fee payable to M&D on a monthly basis (Tr. 154). Accordingly, if in no month since January 1, 1965 did the total brokerage commissions amount to as much as one cent per share, the applicable SEC rule permitted the Fund to ignore recapture in calculating daily net asset value.

The uncontradicted trial testimony of Mr. Maynard, a senior partner in the accounting firm of Price, Waterhouse & Co., was that in no month since January 1, 1965 did the total brokerage commissions paid by the Fund amount to so much as even one-half cent per share (Tr. 147-148). It necessarily follows, as Mr. Maynard testified, that even on the highly unlikely, if not impossible, assumption that *all* of the brokerage commissions paid by the Fund were recaptured and credited against the management fee, the net asset value of the Fund, calculated in accordance with generally accepted accounting practices and SEC rules, would not have been affected (Tr. 146-148, Ex. 161).

As Mr. Maynard testified without contradiction or rebuttal, the Fund's calculation of its net asset value was not affected by the possibility of recapture. The testimony in this case thus renders the *Moses* dicta inapplicable here.

C. The Chemical Fund charter permits the Board of Directors to consider recapture as a matter of business judgment

In addition, even if the Fidelity Fund charter provision relied upon by the Court in *Moses* had some relevance in

that case, it has no relevance here because of another charter provision which entrusts the entire question of the allocation of Chemical Fund brokerage business to the business judgment of the Chemical Fund Board of Directors.

All doubts were resolved on that score when the Chemical Fund shareholders overwhelmingly approved in 1972 an amendment to the certificate of incorporation which made explicit what had been implicit always before. Since that time, the Fund's charter has provided explicitly that it is within the discretion of the Board of Directors to allocate Fund brokerage on the basis of sale of Fund shares and the furnishing of research, statistical and other services. (App. 296, A-31, 32; Ex. 139, pp. 6-7) The shareholders' ratification of the Fund's long-standing brokerage practices, even in light of plaintiff's allegations, is sufficient by itself to prevent the imposition of liability upon Eberstadt or M&D, which acted on the basis of the good-faith business judgment consistently made by the Fund's Board of Directors. See *Saxe* v. *Brady,* 184 A.2d 602, 610 (Del. Ch. 1962).

Consequently, no matter what was the case with respect to the Fidelity Fund charter, the Chemical Fund directors had discretion under the certificate of incorporation of Chemical Fund to decide as a matter of business judgment, as they did, that Eberstadt and M&D should not be involved —for recapture or any other purpose—either in executing portfolio transactions for the Fund or serving as conduits for the recapture of give-ups.

III. The decision by the Fund's directors not to recapture falls within the scope of the "business judgment rule"

The *Moses* case held that "it was the directors of the Fund, not Management, who were the ones to make the decision." (445 F.2d at p. 383). That is precisely what happened here (App. A-70; Tr. 161-162, 163, 168-169, 217).

It was in fact the unaffiliated directors who decided in the exercise of independent business judgment, and with full knowledge of the relevant facts, that Eberstadt and M&D should not become involved directly or indirectly in the brokerage business of the Fund and that it was in the best interests of the Fund and its shareholders for the Fund's portfolio brokerage instead to be allocated to brokers who sold Fund shares or who provided research or statistical services.

Consequently this case is governed by the well-established "business judgment rule" which has been stated as follows:

> "Corporate management is vested in the board of directors. If in the course of management, directors arrive at a decision, within the corporation's powers and their authority, for which there is a reasonable basis, and they act in good faith, as the result of their independent discretion and judgment, and uninfluenced by any consideration other than what they honestly believe to be the best interests of the corporation, a court will not interfere with internal management and substitute its judgment for that of the directors to enjoin or set aside the transaction or to surcharge the directors for any resulting loss." Henn, *Corporations* (1961), p. 364.

The law is well established in this Circuit and elsewhere* that where informed directors make an honest business decision, the courts will not substitute their judgment for that of the directors. For example, in *Fogelson* v. *American Woolen Co.*, 170 F. 2d 660, 662 (2d Cir. 1948), Judge Swan stated that:

> "Courts are properly reluctant to interfere with the business judgment of corporate directors; they do so only if there has been so clear an abuse of discretion as to amount to legal waste." (citations omitted)

See also, United Copper Securities Co. v. *Amalgamated Copper Co.*, 244 U.S. 261, 263-264 (1917); *Ransome Concrete Machinery Co.* v. *Moody*, 282 Fed. 29, 32-33 (2d Cir. 1922).

In the case at bar, not only did the Fund's unaffiliated directors make an informed and independent good-faith business judgment not to engage in recapture, but they acted and relied upon the advice of counsel and upon the existing state of the law.** Thus, after the SEC exposed

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* *McQuillen* v. *National Cash Register Co.*, 112 F.2d 877, 883-884 (4th Cir.) *cert. denied.* 311 U.S. 695 (1940); *Doherty* v. *Mutual Warehouse Co.*, 255 F.2d 489, 490 (5th Cir. 1958); *Greene County National Farm Loan Ass'n* v. *Federal Land Bank*, 152 F.2d 215, 219 (6th Cir.), *cert. denied*, 328 U.S. 834 (1945); *Midland Savings & Loan Co.* v. *Dunmire*, 68 F.2d 249, 252 (10th Cir. 1933); *Consolidated Cement Corp.* v. *Pratt*, 47 F.2d 90, 93 (10th Cir. 1931); *Wall & Beaver Street Corp.* v. *Munson Line*, 58 F. Supp. 190, 116 (D. Md. 1944); *Levitan* v. *Stout*, 97 F. Supp. 105, 114 (W.D. Ky. 1951); *Gruber* v. *Chesapeake & Ohio R.R. Co.*, 158 F. Supp. 593, 603 (N.D. Ohio 1958); *Wiles* v. *Campbell*, 77 F. Supp. 343, 349 (D. Del. 1948). See also *Fletcher Cyclopedia Corporations* § 1039 (Rev. ed. 1965) for a general discussion of the "Business Judgment Rule".

** Counsel's opinion as to the law . . . should in our opinion, protect the officers acting in reliance upon it." *Spirt* v. *Bechtel*, 232 F.2d 241, 247 (2d Cir. 1956).

for public comment its proposed new Rule 10b-10, the Fund's Board of Directors received and relied upon the opinion of the Fund's counsel that the decision whether or not to recapture was a matter of business judgment (App. A-67, 319; Tr. 58-59, 168-169). Following the *Moses* decision in June, 1971, the Board again consulted counsel and was advised that this opinion could still be relied upon (App. A-69, 70; Tr. 170-171).

IV. There was no breach of the management and distribution contracts between the Fund and M&D

As the District Court found, the allocation of Fund brokerage business to encourage the sale of Fund shares and the flow of useful research and statistical information was not a breach of the management and distribution contracts between the Fund and M&D (App. A-78-79, 341; Tr. 86-87, 133, 173-174, 178-180, 195-196, 219).

The research material which M&D receives from brokers, while useful, serves principally to supplement and confirm M&D's own research, to provide outside views, and to provide ideas about particular companies so that M&D can then conduct its own investigation. Such information does not replace M&D's own research or materially reduce its operating costs (Tr. 34, 37, 212-213).

The Fund's directors have always considered allocation of brokerage for this purpose to be in the best interests of the Fund and its shareholders (App. 341; Tr. 173-174, 195, 219). The fact that brokerage would be allocated by M&D for this purpose was always an implicit term of the Fund's management agreement with M&D (Tr. 195-196). Indeed a subcommittee of unaffiliated directors asked that M&D allocate a *larger* amount of brokerage to brokers who provided useful research (App. 341).

As to the allocation of Fund brokerage to brokers who sold Fund shares, this too has always been implicit in the distribution agreement (Tr. 86-87, 195-196; App. 323-324). This method of doing business has always been deemed by the Fund's directors to be in the best interests of the Fund and its shareholders (App. 323, 324, 341; Tr. 71, 77, 174, 178-180, 219).

Generally speaking, the distribution of mutual fund shares is not a profitable business (Tr. 128-129; App. 314). In most of the years since 1967, M&D has sustained losses in the performance of its distribution agreement with the Fund (Ex. 93, Schedule "C"; Ex. 94, Schedule "C"; Ex. 95, Schedule "C"; Ex. 96, Schedule "B"; Ex. A, Schedule "B"; Ex. 81, Schedule "B"; Tr. 128-129). At the same time, M&D has achieved for the Fund a superior record of net sales as compared to the rest of the mutual fund industry (Tr. 28-30, Ex. L). Whatever brokerage, therefore, was allocated to brokers who sold Fund shares served quite effectively to benefit the Fund by providing the cash flow requisite for effective portfolio management; the benefit to M&D, however, was minimal.

To the extent that increased sales theoretically benefitted M&D by increasing the management fee, it should be noted that each dollar expended by M&D in its sales and distribution effort takes close to 15 years to recover through increased management fees (Tr. 133).

Since both contracts were negotiated in the context of an industry-wide practice, any change in that practice which resulted in a significant increase in M&D's costs would necessarily have required consideration of renegotiating the contract (Tr. 195).

It is significant that plaintiff can point to no specific provision of either contract which she claims was violated.

There is no such provision. There is and can be no valid claim of breach of contract when both contracts were executed and performed in the context of a generally prevailing method of business which the Fund directors desired to be continued because they considered it to be in the best interests of the Fund.

V. There was adequate disclosure of Fund brokerage practices to Fund shareholders

Plaintiff poses as an issue on this appeal the adequacy of disclosure in Fund prospectuses and proxy statements "that excess brokerage commissions were being applied for the benefit of the Fund's investment adviser and principal underwriter which, at all times, could have been recaptured and applied for the benefit of the Fund" (Plaintiff's Br., p. 3).

The issue is wholly spurious.

In the first place, there were no "excess" commissions—as plaintiff well knows—for she so stipulated in the pretrial order (App. A-34).

Second, plaintiff's disclosure argument assumes that recapture was mandated as a matter of law, despite the good-faith business judgment of independent directors that recapture was *not* in the best interests of the Fund's shareholders. However, as this Court has held, businessmen are not required to anticipate trends of judicial decision in proxy statements and other corporate disclosure documents. *Newman* v. *Stein*, 464 F.2d 689, 693 n. 10 (2d Cir. 1972), *cert. denied* 409 U.S. 1039 (1972).

Third, it is not correct that "the failure to recapture resulted in substantial profits" to M&D (Plaintiff's Br., p.

3). No evidence is cited to support that assertion and, in fact, there is none.

Fourth, as the District Court found, disclosure to shareholders of Fund brokerage practices was more than adequate (App. A-73-75). Each Fund prospectus since 1965 has disclosed that Eberstadt does not act as broker for the Fund and that Fund brokerage business is allocated to dealers partly on the basis of Fund shares sold and partly on the basis of other services rendered (Ex. 11, p. 7; Ex. 12, p. 8-9; Ex. 13, p. 9-10; Ex. 14, p. 8; Ex. 15, p. 8-9; Ex. 16, p. 9; Ex. 17, p. 12). In the years 1966 through 1971, Fund prospectuses and proxy statements disclosed the total dollar amount of Fund brokerage business, the dollar amount of brokerage business allocated to dealers based on the volume of shares sold and the dollar amount of brokerage business allocated to dealers who provided statistical, research or other services to M&D for the benefit of the Fund (Ex. 12, p. 8-9; Ex. 13, p. 9-10; Ex. 14, p. 8; Ex. 15, p. 8-9; Ex. 16, p. 9; Ex. 17, p. 12; Ex. 29, p. 4; Ex. 30, p. 2-4; Ex. 31, p. 4; Ex. 32, p. 3; Ex. 33, p. 10; Ex. 34, p. 8-9). In 1972 and 1973, Fund prospectuses disclosed substantially the same information in somewhat different format (Ex. 18, p. 10; Ex. 19, p. 8).

There is no substance to plaintiff's arguments that there should also have been disclosure that some brokerage allocations took the form of give-ups and that recapture was possible if Eberstadt received either give-ups or brokerage business. It is difficult to perceive why any prospective purchaser of Fund shares or any Fund shareholder would have had the slightest interest in the mechanics of the give-up or in their dollar amount. His principal interests would be best execution, a fact which is undisputed here, and the existence of any conflicts of interest in the execution of

portfolio transactions. There were no such conflicts here, for Eberstadt neither acted as executing broker nor received any give-ups.

Similarly, it would have been pointless to disclose to shareholders that recapture was theoretically possible, for the directors had decided that there would be no recapture. We know of no rule of disclosure, and plaintiff cites none, which requires discussion in proxy statements or prospectuses of methods of doing business which a board of directors has rejected as a matter of business judgment.

Fifth, plaintiff's disclosure arguments are mere afterthoughts, a fact which surely reflects upon their validity. Even though the complaint alleges in specific terms the brokerage practices attacked on this appeal (App. A-5-8), no claim is made on the basis of inadequate disclosure to Fund shareholders. The complaint conspicuously fails to allege any deficiency whatsoever in disclosure to Fund shareholders. Moreover, in the list of contentions which plaintiff prepared for inclusion in the pre-trial order after completion of discovery, there is likewise no mention of any claim of non-disclosure (App. A-38-40).

Sixth, it is difficult to perceive how a Fund shareholder can claim in a derivative action brought on behalf of the Fund that the Fund was damaged by the falsity of its own prospectuses and proxy statements. No Fund shareholder seeks in this action to rescind a purchase of Fund shares by reason of a false prospectus. The complaint does not seek to invalidate any shareholder vote by reason of any defect in any proxy statement.

Plaintiff cites no evidence to show that the Fund was injured by reason of any defect in its own proxy statements and prospectuses and we assert with confidence that the trial record contains no such evidence.

In short, the disclosure issue which plaintiff belatedly poses borders upon the frivolous.

CONCLUSION

Since plaintiff proved at trial no basis for the imposition of liability, judgment was properly entered for defendants. The judgment should be affirmed.

Respectfully submitted,

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December 17, 1975

ADDENDUM

Section 36, Investment Company Act of 1940, as amended in 1970, 15 U.S.C. § 80a-35:

"(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 80a-1(b) of this title.

"(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with

respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consid-

eration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this title for the purposes of sections 80a-9 and 80a-49 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction

to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section." (Aug. 22, 1940, ch. 686, title I, § 36, 54 Stat. 841; Dec. 14, 1970, Pub. L. 91-547, § 20, 84 Stat. 1428.)

Section 36, Investment Company Act of 1940, 54 Stat. 841:

"The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:

(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate." (Aug. 22, 1940, ch. 686, title I, § 36, 54 Stat. 841.)

Service of two copies of the within brief is hereby admitted this 17th day of December, 1975.

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